VZCZCXRO0284
RR RUEHDE
DE RUEHCV #1466/01 2042132
ZNY CCCCC ZZH
R 232132Z JUL 07
FM AMEMBASSY CARACAS
TO RUEHC/SECSTATE WASHDC 9342
INFO RUEHHH/OPEC COLLECTIVE
RUEHAC/AMEMBASSY ASUNCION 0849
RUEHBO/AMEMBASSY BOGOTA 7433
RUEHBR/AMEMBASSY BRASILIA 5959
RUEHBU/AMEMBASSY BUENOS AIRES 1644
RUEHLP/AMEMBASSY LA PAZ 2554
RUEHPE/AMEMBASSY LIMA 0824
RUEHME/AMEMBASSY MEXICO 4034
RUEHSP/AMEMBASSY PORT OF SPAIN 3450
RUEHQT/AMEMBASSY QUITO 2645
RUEHSG/AMEMBASSY SANTIAGO 3971
RUEHDG/AMEMBASSY SANTO DOMINGO 0480
RUMIAAA/HQ USSOUTHCOM MIAMI FL
RHEHAAA/WHITEHOUSE WASHDC
RHEBAAA/DEPT OF ENERGY
RUCNDT/USMISSION USUN NEW YORK 0890
RUCPDOC/DEPT OF COMMERCE
RUEATRS/DEPT OF TREASURY
RHEHNSC/NSC WASHDC

C O N F I D E N T I A L SECTION 01 OF 04 CARACAS 001466

SIPDIS

SIPDIS

ENERGY FOR CDAY AND ALOCKWOOD
NSC FOR JCARDENAS AND JSHRIER

E.O. 12958: DECL: 07/23/2017
TAGS: EPET ENRG EINV ECON VE
SUBJECT: PDVSA'S "IMPORTANT OPERATIONAL EMERGENCY"

Classified By: Acting Economic Counselor Shawn E. Flatt for Reason 1.4 (D)

¶1. (C) SUMMARY: Luis Vierma, PDVSA's Vice President for Exploration and Production, testified before the Comptroller Committee of the National Assembly on July 18 that PDVSA was facing an "important operational emergency" due to the failure of two bid rounds for drilling rigs. PDVSA's rig count of 112 differs significantly from service company Baker Hughes' count of 82. Local analysts do not believe that PDVSA is producing more than 3.0 million barrels per day as it claims due to the rig count and a lack of investment in recent years. It appears that PDVSA plans to deal with its operational problems via Citgo investment in upstream projects in Venezuela, a greater reliance on service companies, and a drilling program that focuses on quick, short-term results. Citgo would finance the upstream investments via bank financing. The assets of a highly leveraged Citgo may not be as attractive to the holders of arbitration awards against PDVSA if they were used as collateral for bank loans. END SUMMARY

PDVSA'S EMERGENCY

¶2. (SBU) PDVSA's Vice President for Exploration and Production Luis Vierma testified before the Comptroller Committee of the National Assembly on July 18 that PDVSA was facing an "important operational emergency" due to the failure of two bid rounds for drilling rigs. Vierma was testifying before the committee due to allegations of improprieties in a 145 billion Bolivar drilling rig contract. The Reporte newspaper has repeatedly charged Vierma with corrupt practices over the past several months. The charges have been quite detailed and rumor has it that a PDVSA or Energy Ministry insider has been leaking information to the paper.

¶3. (SBU) El Universal newspaper in separate articles quoted Energy Minister and PDVSA President Rafael Ramirez and Vierma as stating the first bid was declared void because its terms did not include a "social responsibility component", was organized separately by operational area, and was for a period of only two years. El Universal quoted Ramirez as stating that operating districts must have unified equipment requests, contracts must be for five years, and all contracts must contain an obligatory social component equal to 10% of the gross amount of the contract.

¶4. (SBU) Following the failure of the first bid round, PDVSA invoked a section of the Public Bidding Law that allowed it to proceed with direct assignment. According to El Universal's account of Vierma's testimony, Vierma stated 63 companies began the bidding process but only 22 actually completed it. Of these 22companies, 12 received contracts for 27 rigs. Verma then admitted that only five of the 12 compnies actually completed the contract. One of the companies that did not complete the contract was Constructora Interbolivariana Multinacional Andina, a Colombian firm that is suspected of being a shell company due to its low level of capitalization. (NOTE: Septel will discuss the Venezuelan Public Bidding Law and its impact on the oil sector. END NOTE)

¶5. (C) A shipping executive and marketing executive told Petroleum Attache (Petatt) and Econ Specialist on June 28 that a number of companies that were awarded bids for drilling rigs were shell companies. The marketing executive claimed that the companies tried to sell their contracts but were unable to do so under Venezuelan law. The owners then

tried to sell the companies to international service companies in order to unload the contracts. The marketing executive stated none of the international companies wanted anything to do with the proposals.

FIGURES LIE AND LIARS FIGURE

¶6. (SBU) According to Vierma's testimony and PDVSA's website, there are currently 112 drilling rigs operating in Venezuela. PDVSA's goals for 2007 were to have 190 rigs operating by the end of the year and to drill 1,700 wells. Vierma stated PDVSA's 2007 budget for rigs was over 3.5 billion USD.

¶7. (C) PDVSA's claim of 112 drilling rigs varies widely with service company Baker Hughes' rig count for Venezuela. According to Baker Hughes, Venezuela had 82 drilling rigs operating in June 2007. Of these 82 rigs, 71 were drilling for oil and 11 for gas.

¶8. (C) Vierma's rig figures and comment about an operational emergency raise real questions about PDVSA's production claims of over 3 million barrels of oil per day. Local analysts have pointed out that PDVSA invested nearly 6 billion USD in the oil sector and had 120 operational drilling rigs in 1997, the year PDVSA hit a maximum crude production level of 3.5 million barrels of oil per day. The 1997 production level was also the result of seven years of increasing investment in the sector. Local analysts estimate that PDVSA invested less than 3.5 billion USD in 2006 and that this amount is hardly enough to support 120 drilling rigs given the sharp increase in operating costs over the last two years. Both Ramirez and Vierma have publicly admitted that rig costs have skyrocketed. Given the 2002-3 strike, the firing of thousands of PDVSA employees, and relatively low levels of investment in recent years, it is very difficult to believe PDVSA's claims that it is producing over 3 million barrels of oil per day.

WHERE DOES PDVSA GO FROM HERE?

¶9. (C) Based on Vierma's comments and information from a Citgo executive, it appears that PDVSA plans to deal with its operational problems via Citgo investment in upstream projects in Venezuela, a greater reliance on service companies, and a drilling program that focuses on quick, short-term results. Despite Vierma's positive spin during the National Assembly hearing, PDVSA's three-prong plan raises more questions than it answers.

¶10. (C) A senior Citgo executive told Petatt and Econ Specialist on July 20 that he has been assigned to draft a proposal for Citgo investment in upstream projects in Venezuela. According to the executive, only three senior executives in Citgo have knowledge of the project. The plan is to be completed and submitted to Citgo President Alejandro Granado the week of July 23. Granado will then present the plan directly to Energy Minister Rafael Ramirez. The executive stated Faja projects are one of the options being considered. He also indicated that the projects will be financed via bank loans. Based on the executive's comments, it appears that the size of Citgo's investment will be based on the amount of money that it can raise in the financial markets. The executive stated Citgo's studies show that the company would make a healthy rate of return from investments in Venezuelan upstream projects.

¶11. (C) COMMENT: PDVSA may be able to kill two birds with one stone if Citgo begins investing in upstream projects in

Venezuela. First, use of Citgo's assets and access to financial markets allows PDVSA to increase investment in the oil sector without exacerbating its cash flow problems. Second, it is not clear if Citgo would have to utilize a PDVSA-controlled joint venture structure with PDVSA in order to invest in Venezuelan upstream projects since it is a wholly owned PDVSA subsidiary. If Citgo does not utilize a joint venture, service and equipment providers may feel more comfortable entering into contracts with Citgo directly for sorely needed equipment and technology. Citgo could draft the contracts with provisions granting arbitration rights and a host of other protections PDVSA is loathe to grant. In addition, if the services and equipment were contracted in the United States, suppliers may be able to avoid the Venezuelan Public Bidding Law. The assets of a highly leveraged Citgo may not be as attractive to the holders of arbitration awards against PDVSA if they were used as collateral for bank loans.

¶12. (C) Given PDVSA's self-acknowledged operational problems, it would seem logical that it would turn to service companies to provide the equipment and technology that it so desperately needs. However, it appears that PDVSA is sending mixed signals regarding service companies. Vierma is quoted on the PDVSA website as stating that PDVSA due to "national security and strategic reasons" must field its own fleet of drilling rigs in order to reduce its vulnerability that it has to third party contracts. He also said PDVSA was equally vulnerable to third party contracts for well services. It is hard to believe that PDVSA will be able to build up a fleet of drilling rigs given high market prices and its current cash flow problems. Even if it could purchase the rigs, it is not clear that it could find a sufficient number of capable crews to run them given the dearth of human capital in the Venezuelan hydrocarbon sector. END COMMENT.

¶13. (C) The media reported the week of July 16 that French service company Schlumberger had signed an operating contract with PDVSA to manage rigs and provide engineering services to PDVSA for the Cerro Negro and Petrozuata strategic association fields. We have been unable to confirm the reports. If true, the move makes a great deal of sense due to the fact that no one believes PDVSA has the wherewithal to adequately run the fields on their own. A local analyst told Petatt on July 19 that he believes Venezuela is moving toward

the Mexico model, whereby the state oil company depends heavily on the service companies for a wide variety of activities. The analyst noted that Schlumberger has done very well in Mexico and thrives in closed, state-dominated markets. He also noted that although service companies can "get the job done", they lack all of the assets and skill sets that first-tier, international oil companies possess. The analyst noted that this lack of skills has caused real problems in Mexico. (COMMENT: We believe that PDVSA, despite Vierma's nationalist rhetoric to the contrary, will eventually have to rely to some extent on the service companies due to its lack of management expertise, human resources, and technology. We concur with the analyst that the service companies will not solve all of PDVSA's problems. Service companies in many ways act as sub-contractors in the construction sector. They are excellent at what they do but they need someone to provide them with overall direction. We do not believe that PDVSA is capable of providing the necessary project management that the service companies need to fully utilize their capabilities. END COMMENT)

¶14. (C) Vierma is also quoted as telling the Comptroller Committee that PDVSA may have to orient its drilling program to increase drilling in the Faja region. Vierma stated that it only takes four days to drill a well in the Faja as

opposed to 200 days in other parts of Venezuela. As a result, he stated PDVSA may focus on drilling more wells in the Faja in order to keep up the volume of production. (COMMENT: Although this sounds good on the surface, the problem is that the Faja produces extra heavy crudes, which must be upgraded or blended before marketing. At this point, it does not appear that the four upgraders currently operating in the Faja are capable of handing a substantial increase in production. Based on conversations with multiple contacts, it also does not appear that PDVSA has sufficient blending facilities or a sufficient supply of lighter crude to mix with extra heavy crudes. As a result, it is difficult to believe that a substantial increase in the flow of extra heavy crudes will alleviate PDVSA's production problems. END COMMENT)

WE ARE NOT MAKING THIS UP

¶15. (C) Ironically, on July 19, the same date that the press reported on Vierma's "operational emergency" testimony, the media reported that PDVSA planned to form seven new affiliates: PDVSA Industrial (the production of equipment for the oil sector); PDVSA Agricola (agriculture); PDVSA Servicios (oil services); PDVSA Ingeieria y Construccion (engineering and construction); PDVSA Desarollo Urbano (urban development and infrastructure); PDVSA Naval (docks and shipbuilding); and PDVSA Gas Popular (gas distribution). We have little doubt that PDVSA's new affiliates will be just as well-run and efficient as their parent.
FRENCH